

## WASHINGTON ECONOMIC TRENDS

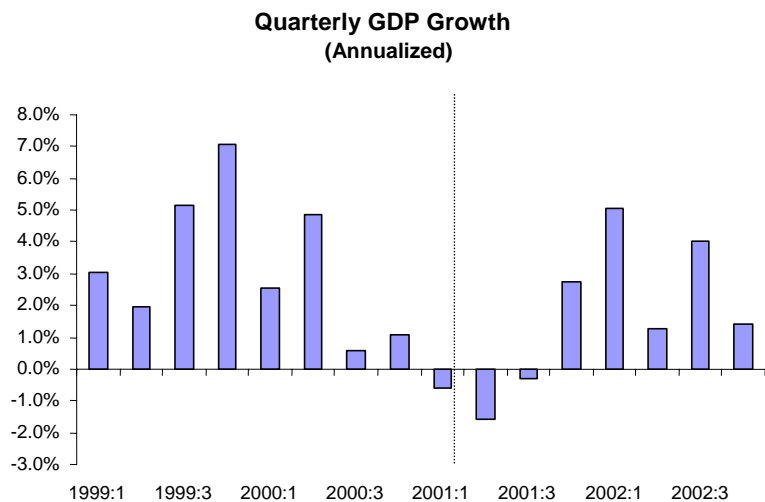
Research Brief No. 15B  
March 2003

# The Dimensions of the National and State Economic Recession

*Contributors: Ta-Win Lin, Jim Schmidt*

The National Bureau of Economic Research has not declared the ending date of the national recession that started in March of 2001. The U.S. Gross Domestic Product (GDP), after three consecutive quarterly declines, has been growing since the fourth quarter of 2001. However, persistent weakness in production and labor markets have made it unclear whether 2002 growth represented a recovery or just the economy bouncing along the bottom of the business cycle. The U.S. economy has actually faltered since the last quarter of 2002, as rising oil prices and the approaching war against Iraq dampened consumer confidence and business prospects. In addition, a slowdown in the global economy hurt U.S. exports.

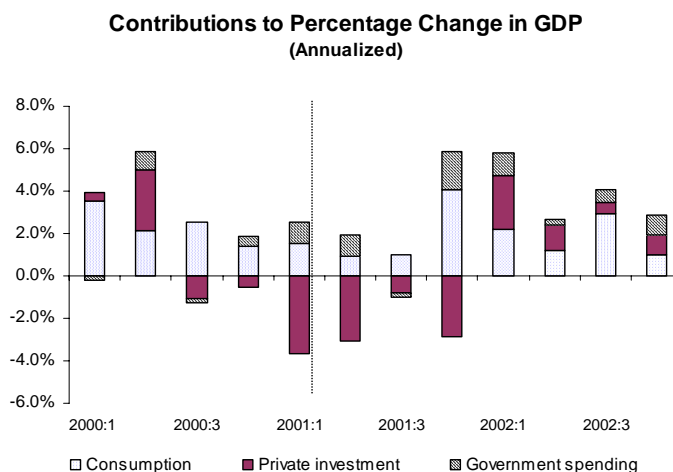
The September 11<sup>th</sup> terrorist attack and its associated effects have had broad and deep impacts on the U.S. economy. All business and government activities have experienced an increasing burden of security costs. Significant investments in security equipment and personnel have already been made in law enforcement, air transportation, cargo inspections at U.S. ports, communication network safety, and immigration and visa control and monitoring. Defense spending has been expanded significantly.



Fiscal conditions at all levels of government have been deteriorating. The slumping economy has drastically reduced tax revenues. Federal and state government spending expanded significantly during the boom period of the late 1990s due to healthy growth in tax revenues and relaxation of the federal spending cap. Adding to fiscal problems are the rising federal and state counter-cyclical expenses (e.g., the unemployment insurance payments, Medicaid, etc.) and federal defense spending.

## National Conditions

***The recovery has been bumpy.*** The 2001 recession was an investment-led, high-tech, and production-side recession. Consumption, which accounts for two-thirds of the total economy, actually performed well during this period. Consumption grew at an annual rate of 4.5 percent in 2001 and 2002. Volatile auto sales, resulting from low financing costs and manufacturer-provided incentives, raised the total consumption level but made the growth path rolling throughout 2002. Since the fourth quarter of 2001, U.S. GDP has been growing, albeit on an uneven path and showed signs of a slowdown in the last quarter of 2002.



***Labor markets remained weak.*** After losing 1.6 million jobs in 2001, total U.S. employment declined only slightly by about 220,000 in 2002. The lack of job growth might be normal during the early phase of a cyclical upturn. However, most of the 2002 reduction occurred in the fourth quarter, signaling renewed labor market weakness. Moreover, job market leading indicators in the opening months of 2003 pointed to continued slack labor demand in the near future -- initial jobless claims are mounting again, while help-wanted advertisement volumes remain near the lowest levels in the past four years.

***Strong housing market provided a stabilizing force.*** Residential investment, inflation-adjusted, grew strongly at an annual average of 7.0 percent throughout 2002, due to lower mortgage rates and rapid housing price appreciation. In addition, vigorous housing activity induced substantial home-related consumption of goods and services such as furniture and appliances. Lower mortgage rates also stimulated home refinancing and equity loans, releasing a substantial amount of disposable funds for homeowners to sustain or even raise consumption.

***Business investment improved, but prospects are clouded by war-related uncertainties.*** Business investment dropped precipitously in 2001, and remained weak throughout the first three quarters of 2002. Consequently, business investment as a share of GDP is now the lowest since 1994. However, profits, which plunged in 2000 and 2001, had been rising for most of 2002. Improved profits led to three consecutive quarterly increases in equipment and software investment. Entering into 2003, anecdotal evidence indicates that the war and terrorist-induced uncertainties have been holding back business investment.

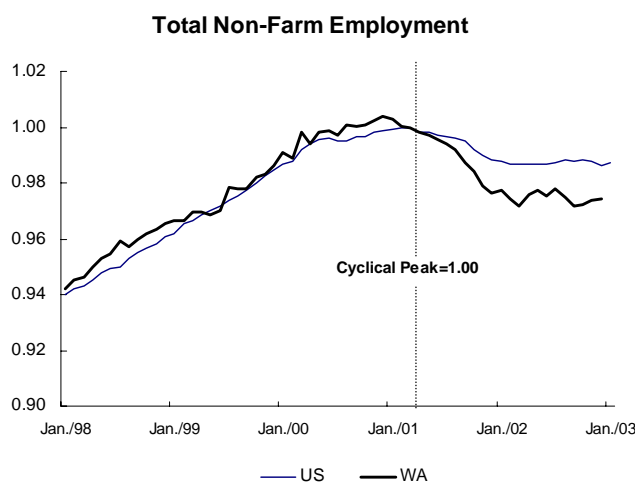
***Productivity continues to advance.*** The post-1995 productivity pick-up is firmly intact. After a cyclical slowdown in 2001, productivity gained 4.8 percent in 2002, the highest in the past 50 years. The record-high jump had a cyclical component in it, but nonetheless supported a strong secular trend. As a result, the economy's labor cost to produce each unit of output dropped 1.8 percent in 2002. Strong productivity gains allow the U.S. domestic producers to remain competitive in the international markets and generate profits despite a lack of pricing power in today's global economy.

**Public spending has helped the economy.** Expanding federal government spending and tax reductions contribute to (near-term) aggregate demand. In the fourth quarter of 2002, federal outlays accounted for half of the 1.4 percent gain in GDP. However, the benefit of public spending to the economy has its limit. When the economic growth accelerates, further outsized expansion in government spending accompanied by budget shortfalls will channel funds away from private investment and dampen productivity growth.

## Washington Conditions

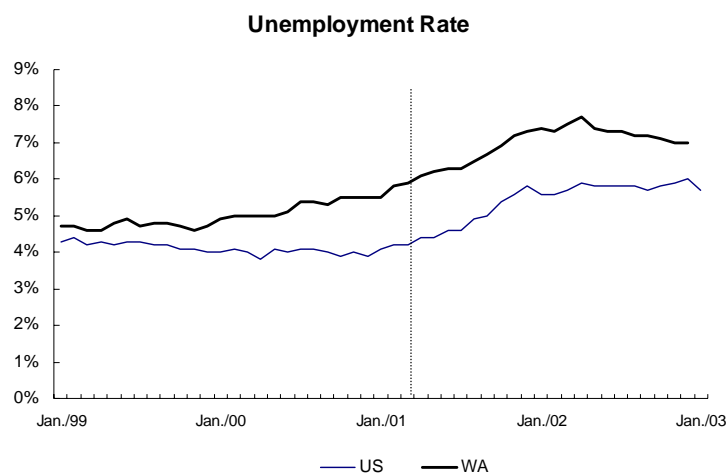
### ***Total employment stabilized, but subsequent growth remained weak.***

Employment in Washington declined 2.8 percent, or 75,500 jobs, in 2001. The employment level reached bottom in April of 2002. However, a strong rebound was not realized and state employment remained around the 2.64 million level throughout 2002. Both the state and the nation seemed to experience a renewed weakness in the job market at the end of 2002. In the past two years, Washington lost 3.2 percent of its total employment, a more severe decline than the national average of 1.3 percent.



### ***Unemployment rate improved slowly.***

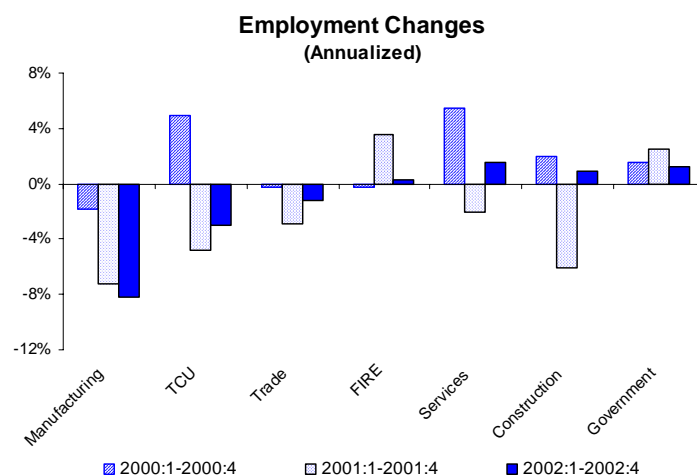
When the national recession began, jobless rate in the state was fairly low at 5.5 percent. The state unemployment rate then climbed for five quarters and peaked in April of 2002 at 7.7 percent, which was still moderately low relative to what the state experienced in the past recessions. The rate then gradually declined and, by the end of 2002, reached 7.0 percent level. The slow improvement in the unemployment rate might not be unusual in the backdrop of an uncertain cyclical recovery, as limited employment growth was offset by more people entering into the labor force.



Washington labor force shrank by 1.2 percent and 1.7 percent in 2000 and 2001, respectively. Employment reductions and rising unemployment rates are the major factors contributing to the labor force declines, as some potential workers were discouraged by poor job prospects. However, in 2002, the improved employment outlook reversed the downward trend and the state's workforce grew 3 percent.

***Reduction in manufacturing employment has not stopped.*** The state suffered five consecutive years of losses in manufacturing jobs. Cutbacks in the aerospace industry accounted for nearly all the losses in 1999 and 2000. In 2001, aerospace employment held on but other manufacturing sectors, especially high-tech, collapsed; and total Washington manufacturing employment was reduced by 7.2 percent. In 2002, the aerospace industry got into a new downward adjustment cycle; and other manufacturing sectors also were declining, albeit at a slower pace than in the previous year.

Consequently, manufacturing employment in the state dropped another 8.2 percent, or 26,800 jobs. Over the past five years, the state lost 79,000 manufacturing jobs, 48,000 of them occurred since the national recession started.

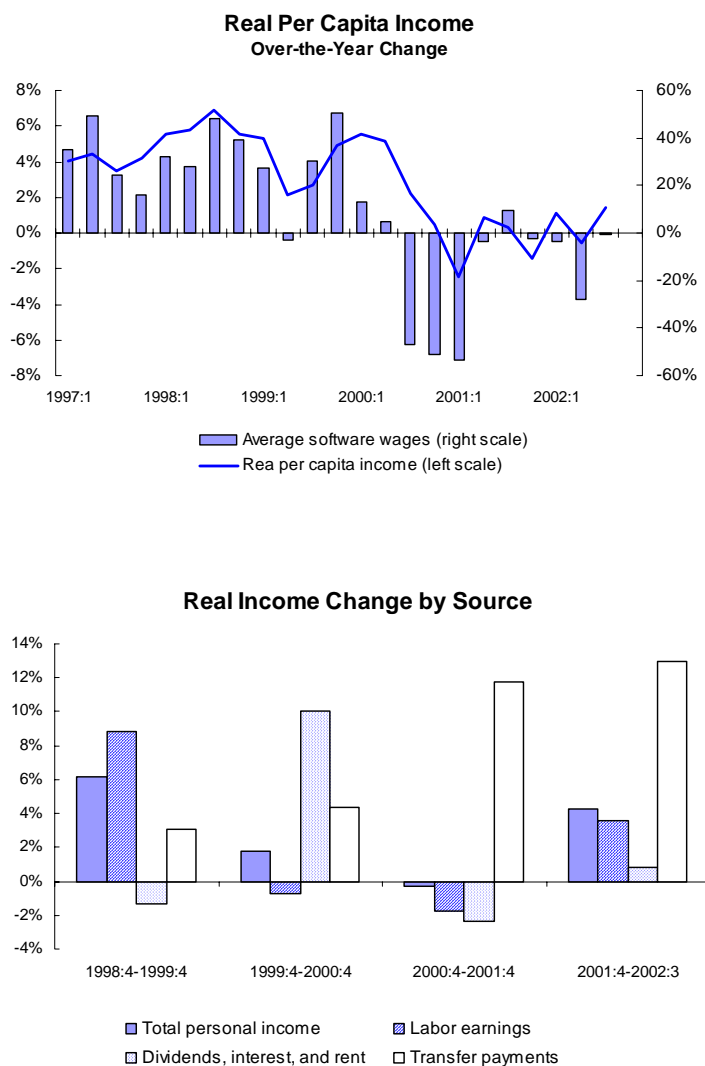


***TCU (transportation, communication, and utilities) restructuring continued.*** TCU employment in the state dropped 4.8 percent and 3.1 percent in 2001 and 2002, respectively. Both communication and transportation industries suffered from excess capacity and soft demand. The September 11 shock and subsequent terror threats have been haunting air transportation worldwide. All major airlines in the nation have been facing heavy losses and debts; United Airline is already operating under Chapter 11 bankruptcy protection. For communication industry the difficulty resulted from over-investment in the late 1990s; job loss occurred as the industry reorganized and consolidated operations.

***FIRE (finance, insurance, and real estate) benefited from the strong housing market.*** Employment in FIRE remained flat in 2002, after increasing an impressive 3.6 percent in 2001. Basically, job growth in finance and real estate sectors offset the decline in the insurance industry. Real estate employment growth in the state rose from 1.4 percent in 2001 to 3.3 percent in 2002, due mainly to the strong housing market.

***Consumer services performed better than business services.*** Total service employment increased 1.5 percent in 2002. Business services continued to lose jobs by 1.6 percent, but it represented a more stabilized condition relative to the heavy loss of 12.3 percent in the previous year. Lodging and legal services remained flat in 2002; other consumer-oriented services such as personal services, health services, fared better with growth in the positive territory.

***Per capita income gradually recovered.*** In the late 1990s, inflation-adjusted per capita income in the state increased more than 6 percent per year. The growth nearly stopped at a mere 0.5 percent rate in 2000; and in 2001, the recession caused the state's per capita income to decline 0.7 percent, before rebounding to an estimated 1.0 percent increase in 2002. The fluctuations in Washington per capita income growth during the period were driven by wages of the software industry. The stock option gains propelled the average wage of the Washington software industry to grow over 50 percent annually in the booming years of the late 1990s and, in 2000 as the stock market started going south, the vanishing option income depressed the average wages to nearly 50 percent below the level a year ago.



***The composition of total personal income varies at different stages of a business cycle.*** The inflation-adjusted labor earnings declined in 2000 and 2001 when the state economy dipped into a recession, and then grew again at an annual rate of 3.5 percent during the first three quarters of 2002. Transfer payments, with a major counter-cyclical component, registered only a 3 percent yearly growth during the booming period between 1997 and 1999, but then rose at double-digit annual rates in 2001 and 2002. As a result, transfer payments accounted for 14.0 percent of total Washington personal income at the end of 2002, compared to the 11.3 percent share right before the recession started.

### Implications for the Recovery

Healthy consumer spending and a strong housing market carried the economy forward throughout 2002. Business investment as a share of GDP is now the lowest since 1994. Profits, the driver of business investment, plunged in 2000-01 but had been rising in 2002. However, the low capacity utilization rate suggests that strong business investment cannot be expected in the near future. This implies a continued soft demand for high-tech manufacturing products and weak product prices.

After lowering interest rates 11 times in 2001, last November the Federal Reserve Bank cut both the discount rate and the target for the federal funds rate by 0.5 percentage point to 0.75 percent and 1.25 percent, respectively. The Fed claimed the move was an “insurance” to counteract increasing “geopolitical risks” and “assure a sustained recovery”. The rates are now the lowest in the past four decades. The Fed also signaled that additional actions could be warranted if softness persists or new danger surfaces. The monetary authority’s uttered determination is alleviating. But the question is whether the monetary actions, whose effects usually have a rather long lag, can offset the imminent Iraq War-related shocks on oil supply and business investment.

In the past two years, federal tax cuts, which increased (after-tax) disposable income, helped support consumer consumption. Strong housing price appreciation raised housing equity, and lower interest rates reduced mortgage loan payments; both made more funds available for homeowners to finance other purchases. This offset the negative effect of the stock market’s poor performance on consumer spending. However, housing prices in most of the markets have reached such high levels that the appreciation trend cannot be sustained. And mortgage rates are now so low that there is limited room for downward moves. Moreover, Iraq war-related anxieties are harming consumer confidence and dampening consumption.

The President just proposed an ambitious budget package that includes more tax cuts. But, in light of the projected huge federal budget deficit in the years ahead, the Congress will very likely trim the proposed package down. Besides, the benefit of expanding federal spending to the economy will be partially offset by the shrinking state and local government expenditures.

Washington’s recovery is likely to lag and be weaker than the nation’s. The state’s aerospace industry has not completed its downward adjustment. Other manufacturing sectors, especially high-tech, continue grappling with soft demand and prices. And the prevailing global slowdown constrains the state’s exports.

Until the outcome of the war in the Middle East becomes clearer, the on-going situation is expected to hurt the state economy. Heightened energy prices squeeze real personal income and inhibit consumption. Almost all major domestic airlines are struggling to survive the war-induced oil price hikes, reduction in air traffic, and soaring security costs. All these will further depress the production and employment of the aerospace industry in Washington.

### Washington Non-Agricultural Wage and Salary Employment (Seasonally Adjusted)

<i>(Thousands)</i>	1 <sup>st</sup> Qtr./ 1998	1 <sup>st</sup> Qtr./ 1999	1 <sup>st</sup> Qtr./ 2000	1 <sup>st</sup> Qtr./ 2001	1 <sup>st</sup> Qtr./ 2002	4 <sup>th</sup> Qtr./ 2002
TOTAL	2566.7	2629.0	2697.2	2720.2	2648.1	2645.4
MANUFACTURING	381.1	371.1	352.0	347.9	318.0	299.8
Durable Goods	272.2	263.1	242.9	242.1	217.5	202.9
Aluminum	7.9	7.1	7.1	5.8	3.8	3.1
Industrial Machinery & Equipment	27.1	25.0	25.3	25.4	22.1	21.6
Electronic & Other Electric Equip.	18.2	18.4	19.3	21.2	16.1	14.2
Transportation Equipment	127.2	122.6	100.4	100.9	92.8	84.4
Aircraft and Parts	112.1	106.8	84.5	86.8	80.4	71.7
Instruments & Related	15.1	14.8	14.6	14.6	14.4	14.1
Nondurable Goods	108.9	107.9	109.1	105.8	100.5	96.9
CONSTRUCTION	140.2	149.8	160.7	159.8	150.2	152.2
TRANSP., COMM. & UTIL.	133.9	137.8	144.0	149.3	140.6	137.9
Transportation	89.7	91.4	93.3	94.8	88.9	88.2
Communications	28.9	31.0	34.4	38.0	35.2	33.5
Electric, Gas and Sanitary Services	15.3	15.4	16.3	16.5	16.5	16.2
WHOLESALE & RETAIL TRADE	616.3	632.4	647.9	640.9	620.5	616.0
Wholesale Trade	152.2	154.2	154.4	146.6	139.4	137.3
Retail Trade	464.1	478.2	493.6	494.2	481.1	478.6
FINANCE, INSURANCE & REAL ESTATE	131.7	137.4	137.8	138.9	140.7	143.0
Finance	57.2	60.6	61.5	62.5	63.9	65.7
Insurance	40.0	41.7	40.9	41.6	41.3	40.8
Real Estate	34.5	35.1	35.5	34.9	35.5	36.5
SERVICES	697.5	726.8	771.8	780.2	763.6	775.4
Business Services	150.6	161.7	181.5	187.6	165.6	165.5
Health Services	183.2	187.4	190.4	195.6	201.5	206.1
GOVERNMENT	462.8	470.4	479.4	499.7	511.5	518.1
Federal	67.6	68.3	68.0	67.6	68.4	71.3
State	133.1	136.6	139.7	142.0	145.5	145.3
State Education	71.3	72.6	74.7	76.2	78.6	78.5
Local	262.1	265.5	271.8	290.2	297.7	301.5
Local Education	139.5	141.3	144.3	147.5	150.9	153.4

Sources: *Economic and Revenue Forecast Council, Employment Security Department.*